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Supreme Court of the United States

OCTOBER TERM, 1941.

No. 907.

THE CITIZENS NATIONAL BANK OF KIRKSVILLE, MISSOURI, PETITIONER,

VS.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

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COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

Petitioner, The Citizens National Bank of Kirksville, Missouri, respectfully prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Eighth Circuit entered in the above entitled cause.

OPINION BELOW.

The opinion of the Board of Tax Appeals (R. 26-35) is reported in 42 B. T. A. 539. The opinion of the Circuit Court of Appeals (R. 46-53) is reported in 122 F. 2d 1011.

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered on October 16, 1941 (R. 54); a petition for rehearing was filed (R. 55-62), which was overruled on November 4, 1941 (R. 61).

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925, United States Code, Title 28, Section 347.

QUESTIONS PRESENTED.

Whether the annual payment of $2,400 to Frank Baird during 1936, the year herein involved, for his life interest in the property occupied by the petitioner constitutes an allowable deduction from its income:

(1) As exhaustion or amortization of the terminable interest acquired from Frank Baird, or

(2) as annuity payments made in the acquisition of Frank Baird's interest in the property; or,

(3) in the alternative, whether the sum of $1,971.44 representing that portion of the $2,400 payment made in 1936 applicable to the payment for Frank Baird's interest in the building that was demolished in 1923 is deductible.

STATUTES AND REGULATIONS INVOLVED.

Revenue Act of 1936, Chapter 690, 49 Statute 1658:

Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

(a) Expenses.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for

personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a grade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * * * *

(f) Losses by Corporations.—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * * * *

(1) Depreciation.—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

Article 23 (e)—2 of Treasury Department Regulations 94, (Revenue Act of 1936):

Voluntary removal of buildings.—Loss due to the voluntary removal or demolition of old buildings, the scrapping of old machinery, equipment, etc., incident to renewals and replacements is deductible from gross income. When a taxpayer buys real estate upon which is located a building, which he proceeds to raze with a view to erecting thereon another building, it will be considered that the taxpayer has sustained no deductible loss by reason of the demolition of the old building, and no deductible expense on account of the cost of such removal, the value of the real estate,

exclusive of old improvements, being presumably equal to the purchase price of the land and building plus the cost of removing the useless building.

STATEMENT.

For its finding of facts the Board of Tax Appeals adopted the stipulation of facts entered into between the parties (R. 17-27), a summary of the portions thereof pertinent to the issues presented are as follows:

The petitioner is a corporation engaged in the general banking business at Kirksville, Missouri (R. 17). From 1906 to 1912 it rented the premises occupied by it from William T. Baird who died testate in the latter year (R. 17-18). Under his Will his son Frank Baird was given the income from the property during his life time with remainder to his daughter, Alta Baird Belshe (R. 22). The Will further provides that if the building is destroyed by fire or tornado Alta Baird Belshe "is to have the right to rebuild using the insurance money in such rebuilding, and to pay Frank an amount monthly equal to the amount he had been realizing net out of the rental" of the property (R. 22).

On April 21, 1920, the bank entered into a contract with Frank Baird whereby he conveyed his interest in the property to the bank in consideration of the payment to him of $200 a month during life, Frank agreeing to keep the roof in repair and giving the bank the right to make other repairs. The contract further provides that Frank Baird keep the building insured and in the event the building is destroyed by fire or storm, the rights and liabilities of the bank therein granted and created shall end, and the parties thereto shall stand in the same relation to each other as if the contract had never been made (R. 18-19).

On August 17, 1920, the bank purchased the remainder interest in the property from Alta Baird Belshe for $10,000 (R. 20).

The building was in need of repairs (R. 18) and on December 4, 1920, the bank set aside the sum of $5,000 for "improvements of building fund," and equal amounts were set aside in 1921 and 1922, making a total of $15,000 for this purpose (R. 20).

On January 10, 1923, the bank authorized repairs and alterations to be made to the building and to install new fixtures (R. 20). It was then found to be more practical because of the damaged condition of the building to demolish it and to construct a new building. This was done. A new building was constructed at a cost of $43,096.96, and the bank has since occupied the first floor of the new building (R. 20).

The bank paid Frank Baird $200 a month from 1920 to 1936, inclusive, and Baird paid insurance, under the terms of the agreement, averaging $33.84 a year, or $2.82 a month, leaving an average monthly net income of $197.18 (R. 20-21).

Frank Baird was 61 years of age April 21, 1920, and had a life expectancy based on mortality tables of 13.47 years. The value of an annuity of $197.18 a month similarly computed as of April 21, 1920, is $21,918.37. On the last date mentioned the fair market value of the land and building was $35,000, and of the land alone $6,250 (R. 21).

On its income tax return for 1936, filed on a cash receipts and disbursement basis (R. 17), the bank claimed the payment to Frank Baird of $2,400 as a deduction from income which was disallowed by the Commissioner (R. 8, 19). The bank appealed to the Board of Tax Appeals (R. 2-15), where the action of the Commissioner was sustained (R. 26-35). The Circuit Court of Appeals affirmed (R. 54).

SPECIFICATION OF ERRORS TO BE URGED.

The Circuit Court of Appeals erred:

1. In holding that the payment to Frank Baird of $2,400 in 1936 did not constitute an allowable deduction

from petitioner's gross income as (1) exhaustion or amortization of the terminable interest acquired from Frank Baird, or (2) as annuity payments made in the acquisition of Frank Baird's interest in the property, or, (3) in the alternative, the sum of $1,971.44 representing that portion of the $2,400 payment applicable to the payment for Frank Baird's interest in the building that was demolished in 1923 was not allowed as a deduction from gross income in 1936.

2. In affirming the decision of the Board of Tax Appeals.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT.

I.

(1) In denying the petitioner the right to deduct from its gross income the annual payment of $2,400 to Frank Baird in 1936, as exhaustion or amortization of the terminable interest acquired from him, the Circuit Court erroneously construed an important federal statute in direct conflict with a decision of this Court.

(a) The Circuit Court erroneously held that the payments to Frank Baird come within and are expressly prohibited by the provisions contained in Section 23 (a) of the Revenue Act of 1936, Chapter 690, 49 Stat. 1658, which allows a deduction for "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property," which deduction is limited to "property to which the taxpayer has not taken or is not taking title or in which he has no equity." In the proceedings below, neither the petitioner nor respondent regarded these payments as coming within the above provision as "rentals or other payments." The Circuit Court expressly held that these payments constitute a "part of the purchase price" of the life estate and therefore held that the payments come within the term "or other payments" and that the deduction was expressly prohibited since petitioner was "taking title or in which it had an equity" (R. 50-51). In *Duffy* v. *Central Railway Company*, 268 U. S. 60, l. c. 64, 69 L. Ed. 846, wherein the meaning of "or other payments," as contained in this provision, is defined as meaning "to bring in payments, *ejusdem generis* with 'rentals,' such as taxes, insurance, interest on mortgages, and the like, constituting liabilities of the lessor on ac-

count of the leased premises which the lessee has covenanted to pay."

(b) The decision of the Circuit Court is in direct conflict with the Court's definition of the term "or other payments," which interpretation removes all possible doubt that the payments herein involved do not come within this term. Since the above quoted restrictions do not relate to any of the other deductions permissible under Section 23 (a), *supra*, such as "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" etc., it is therefore immaterial as to whether or not petitioner was "taking title, or in which it has an equity" in determining its right to the deduction under the other provisions of this Section. Also, contrary to the statement contained in the Circuit Court's opinion (R. 51), petitioner at no time contended that in 1936 it had not "taken," was not "taking title," and that it had no "equity" in the property.

(c) Unless the Circuit Court's erroneous interpretation of Section 23 (a), *Supra*, is rectified by this Court it will not only deprive petitioner of a deduction authorized by law but will no doubt result in confusion and much litigation as to future interpretation of this Section.

(2) In denying the deduction as exhaustion or amortization of the terminable estate acquired from Frank Baird, the decision of the Circuit Court is in direct conflict with that of this Court and the United States Circuit Court of Appeals for the First, Second, Third, Fifth and Sixth Circuits in the following cases:

Duffy v. *Central Railroad Company*, 268 U. S. 60, l. c. 64, 69 L. Ed. 846.

Davison v. *Comm.*, 2nd Cir., 60 F. 2d 50.

Baton Coal Company v. *Comm.*, 3rd Cir., 51 F. 2d 469.

King Amusement Company v. *Commissioner of Internal Revenue*, 6th Cir., 44 F. 2d 709.

United States v. *Boston & Providence R. R. Corp.*, 1st Cir., 37 F. 2d 670.
Galatoire Bros. v. *Lines*, 5th Cir., 23 F. 2d 676.

(a) Each of the above decisions hold that payments for a leasehold estate and the capital cost thereof is returnable by annual deductions spead over the term of the estate. Since the payments herein involved are required to be made in equal annual payments during the life of Frank Baird the amount paid each year constitutes an allowable deduction in the year payments are made in accordance with the above decisions and Section 23 (a), *Supra*, or Section 23 (1) of the Revenue Act of 1936, Chapter 690, 49 Stat. 1660. In the case of *Davison* v. *Comm.*, *Supra*, wherein the taxpayer paid a single sum for a leasehold and an option to purchase which taxpayer later exercised, referring to the single sum payment for the leasehold and the option, the Court said, l. c. 52:

> "So much of it as represents the cost of acquiring the leasehold should be regarded as an exhaustible capital investment returnable by annual deductions spread over the term of the lease."

(b) The contract whereby petitioner acquired Frank Baird's life estate in the property contains the express provision that his life estate would revert to him in the event the building was destroyed by fire or storm, and petitioner would thereupon be relieved of making any further payments (R. 19). The remainder interest was owned by Alta Baird Belshe and her father's Will provided that in case of such destruction she "is to have the right to rebuild using the insurance money in such building, and to pay Frank an amount monthly equal to the amount he had been realizing net" from the property (R. 22). Subsequent to acquiring Frank Baird's life estate petitioner acquired the remainder interest, and thereby acquired the right to rebuild in the event of such destruction and to continue the payments. If, however, at

the time of such destruction the petitioner did not deem it advisable to rebuild and continue the payments to Frank Baird and elected not to do so, then Frank Baird would immediately be reinvested with his life estate. Furthermore, if petitioner did elect to rebuild in such event, under the express provisions of the Will, the property is charged with the liability to continue the payments to Frank Baird, and if the payments are not continued he would be entitled to regain full possession of the property for the remainder of his life. Therefore, Frank Baird has at all times had, and will continue to have until his death, a contingent reversionary interest in the property which constitutes an intermediate estate and prevented the interest acquired by petitioner from merging, and consequently the two estates have remained separate.

The decisions of the Missouri Courts as well as other courts uniformly hold that there cannot be a merger of estates so long as there is outstanding an intermediate estate. *Willis et al.* v. *Robinson,* 291 Mo. 650, 237 S. W. 1030 (S. Ct. Mo.); *Morgan et al.* v. *York,* 91 S. W. 2d 244 (Mo. App.), and *Hospes* v. *Almstedt,* 83 Mo. 473. The last two cases also hold that mergers are not favored in courts of law or equity, and even though there is no outstanding intermediate estate there is no merger when that is the intention; and in the absence of evidence to the contrary, the intention will be presumed to accord with the best interest of the interested party.

The payments involved herein are only for the life estate and no deduction is claimed for the cost of the remainder interest, and under the authorities cited constitutes an allowable deduction from income. The Circuit Court said that the question as to whether or not there was a merger was not material (R. 50), and held that the deduction was expressly prohibited by Section 23 (a), *Supra.* The Board of Tax Appeals did not make a determination as to whether or not there was a merger (R. 34, 35).

II.

(1) In denying petitioner the right to deduct from its gross income the $2,400 paid to Frank Baird in 1936 as annuity payments, the decision of the Circuit Court is in direct conflict with that of the United States Circuit Court of Appeals for the Second Circuit in the case of *Commissioner of Internal Revenue* v. *John C. Moore Corporation,* 42 F. 2d 186.

(a) Petitioner's agreement to pay Frank Baird $200 per month for life (less an average of $2.82 per month for insurance or a net amount of $197.18) constitutes a contract to pay an annuity; that the value of such annuity payments based on Baird's life expectancy is $21,918.37, which payments had been made by 1933 plus the sum of $10,000 paid for the remainder interest making a total consideration for the property of $31,918.37. The fair market value of the property was $35,000. The payments made to Frank Baird by January 1, 1936, amounted to $37,600, which together with the amount paid for the remainder interest of $10,000 makes the total payments made by petitioner for the property as at that date of $47,600.

(b) All payments subsequent to 1933 constitutes an expense or loss to the petitioner under the provisions of Section 23 (f) of the Revenue Act of 1936, Chapter 690, 49 Stat. 1659. In the case of *Commissioner of Internal Revenue* v. *John C. Moore Corporation, Supra,* the Court said, l. c. 188:

> "2. We find no difficulty in approving the method employed by the Board in treating the transaction as a sale of an annuity to Mrs. Moore in return for her conveyance of property agreed to be worth $80,000. It is not necessary to predicate the result on the fiction of dividing the sale of the property and the purchase of the annuity, each for $80,000, into two transactions. An annuity writer can accept property for his annuity agreement as well as cash."

The determining factors in that case are almost identical with the facts in the instant case and it is held that all payments after the life expectancy of the annuitant was reached constitutes an allowable deduction as a loss or expense.

III.

(1) In denying petitioner's alternative contention that it is entitled to deduct from its gross income the sum of $1,971.44 representing that portion of the $2,400 payment made in 1936 applicable to the payment for Frank Baird's interest in the building that was demolished in 1923, the decision of the Circuit Court is in direct conflict with that of this Court and the United States Circuit Court of Appeals for the First, Second, Third and Sixth Circuits in the following cases:

Eckert v. *Burnet*, 283 U. S. 140, 75 L. Ed. 911, 51 S. Ct. 373.

Helvering v. *Price*, 309 U. S. 409, 84 L. Ed. 836.

Jenkins et al. v. *Bitgood*, 101 F. 2d 17 (C. C. A. 2d).

Page v. *Rhode Island Hospital Trust Company*, 88 F. 2d 192 (C. C. A. 1st).

Insurance Finance Corporation v. *Commissioner*, 84 F. 2d 382 (C. C. A. 3rd).

Landers Bros. Co. v. *Commissioner*, 60 F. 2d 85 (C. C. A. 6th).

(a) On January 10, 1923, petitioner authorized repairs and alterations to be made to the building and to install new fixtures. It was then found to be more practical because of the damaged condition of the building to demolish it and construct a new one, which was done. In 1920, when Frank Baird's interest was acquired, the fair market value of the land and building was $35,000, of which $6,250 represents the land and $28,750 the building. The portion of the payments made to Frank Baird in each year that is applicable to the building is 28,750/35,000 of $2,400 or $1,971.44. The Circuit Court erroneously held

that there was no definitely ascertained base upon which to calculate the loss; that the fair market value of the property furnishes no basis for determining loss sustained by destruction of property; and that the cost cannot be ascertained until after Frank Baird's death (R. 53). It will be seen that a definitely ascertained base is established and that the fair market value of the property is only used to ascertain the portion of the payments made each year that is applicable to the building, and no other method can be used to determine this factor, even after Frank Baird's death; and that the portion of the annual payments represent petitioner's loss as a result of the building having been demolished is definitely established, and to await Frank Baird's death can have no bearing in determining the resulting loss actually sustained in each year.

(b) This deduction is claimed under the provision of Section 23 (f) of the Revenue Act of 1936, 49 Stat. 1659, and Article 23 (e)—2 of Treasury Department Regulations 94 (Revenue Act of 1936), and is based on the actual cash paid out during 1936 that is applicable to Frank Baird's interest in the building that was demolished in 1923. No one can deny that such payments represent a loss to petitioner against which there is no off-set, and for which there is no possibility of ever realizing anything under any conceivable circumstances; and since petitioner filed its return on a cash receipts and disbursements basis it can only claim a deduction for the loss as actual cash payments are made.

(c) The Circuit Court incorrectly held that the decision in the case of *Eckert* v. *Burnet, Supra,* which case involved bad debts, was not in point (R. 53). In a later decision by this Court in the case of *Helvering* v. *Price, Supra,* it is expressly held that the decision in the Eckert case applies and is controlling as to a deduction claimed for a loss upon a contract of guaranty allowable under

the provision of Section 23 (e) of the Revenue Act of 1932, 47 Stat. 180. The identical provision applicable therein is contained in Section 23 (e) of the Revenue Act of 1936, 49 Stat. 1659. Section 23 (e), *Supra*, provides for losses as to individuals. The deduction in the instant case is claimed under provisions of Section 23 (f) of the Revenue Act of 1936, *Supra*, which provides for losses as to corporations. Both Sections 23 (e) and 23 (f), *Supra*, provide that "losses sustained during the taxable year and not compensated for by insurance or otherwise" constitute allowable deductions from income.

(d) The decisions in the other cases cited above also hold that where the taxpayer is on a cash receipts and disbursements basis that deductions for losses can only be taken in the year or years when actual payments in cash or its equivalent are made, even though the loss is definitely established in a different year and the decision of the Circuit Court is in direct conflct with these decisions.

CONCLUSION.

Wherefore, it is respectfully submitted that this petition for a Writ of Certiorari should be granted.

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